DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 15428
San Diego, Calif. 92115

36 Letters per Year—$60.00 Annually

Registered with the Securities Exchange Commission

November 6, 1968 Letter 409

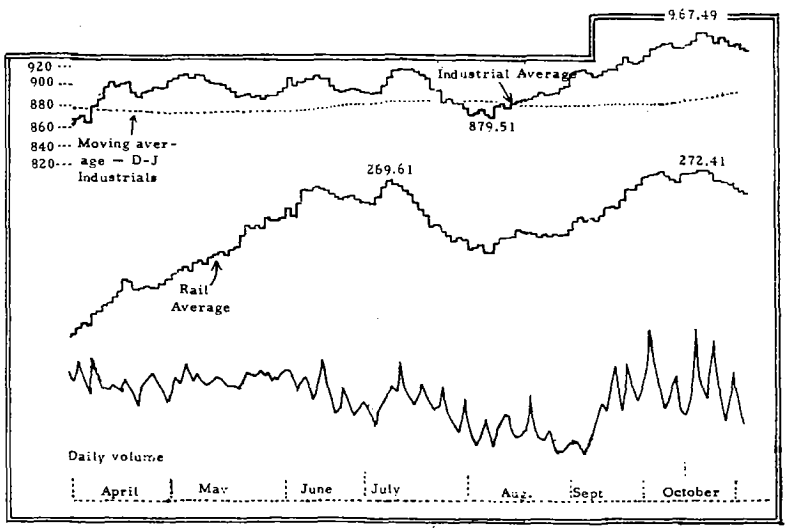
THE MARKET: People have a habit of forgetting that the function of the market is to look ahead—to discount. What everyone knows, said William Hamilton, second editor of the Wall Street Journal, ceases to be a factor in the market.

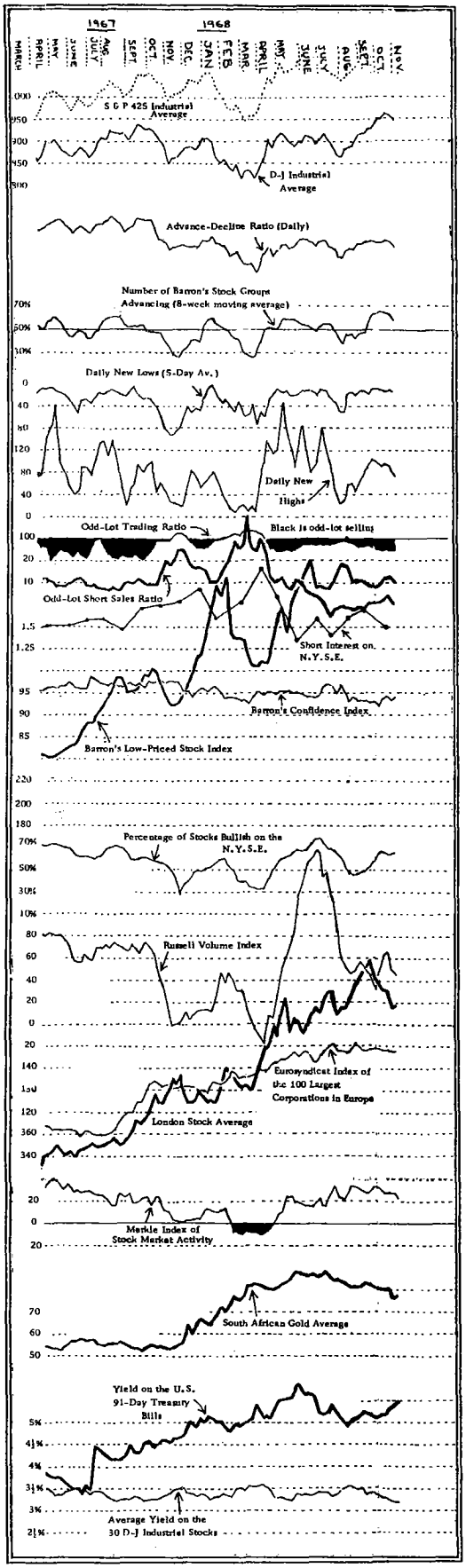
It was therefore no surprise when the news of the bombing halt in North Vietnam failed to set off the widely-advertised "coming upward explosion." As I have said before, the news of a bombing halt and a step-up in negotiations has been an influence on the market for weeks and probably months. The market has been discounting the probability of a bombing halt, and when the news broke it was old hat to traders and speculators.

At the same time, the technical position of the market may have been saying something else, something quite at variance with the "coming peace rally" thesis. Note the chart on page 2. Here we see the D-J Industrial Average moving above its 1967 peak of 943.08, to a 1968 high of 967.49. On the face of it, this appeared to be a bullish development. Yet it is a fact that the Averages often serve as a disguise for informed distribution, and distribution can often be detected by comparing the action of the averages with other technical instruments.

It is well to note that the advance-decline ratio has failed by a wide margin to confirm the breakout of the Dow above its 1967 high. In fact, the recent rally in the advance-decline barely managed to better the earlier June-July peaks. Thus we have a major non-confirmation in that the A-D ratio has failed to confirm the upward penetration of the Industrial Average through the 1967 high.

Equally indicative of technical weakness is the pattern of daily new highs on the N.Y.S.E. Again referring to the page 2 chart we see that the height of strength in the general market, as measured by new highs, occurred in June. Since that time, despite the continuing show of



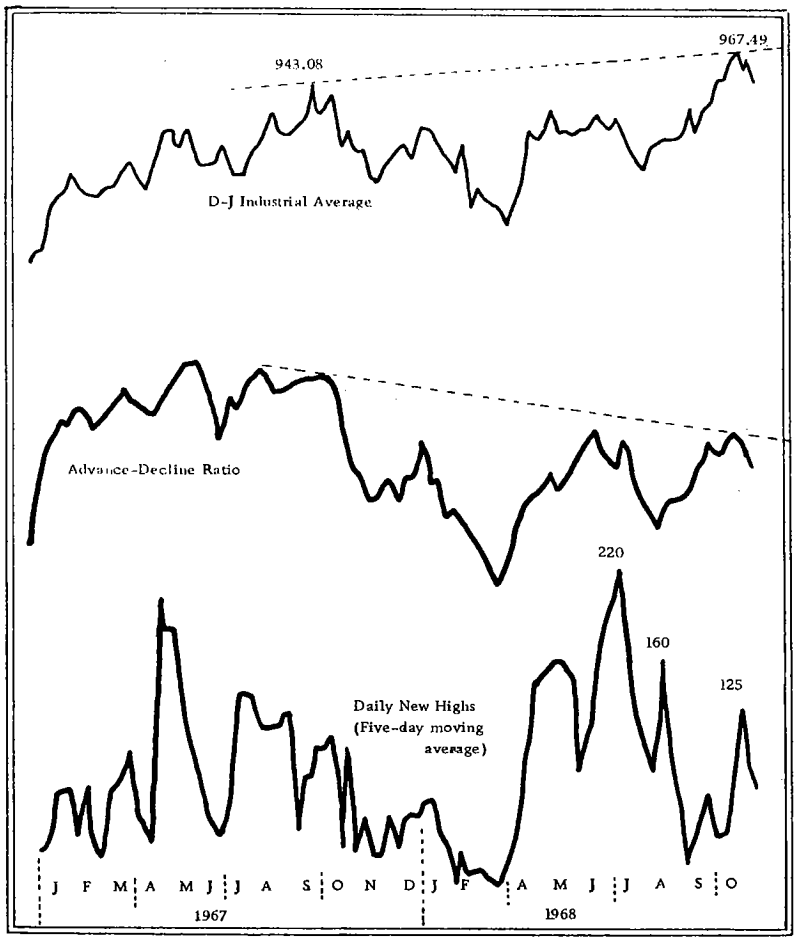

1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline Ratio (Daily)
Number of Barron's Stock Groups Advancing (8-week moving average)
Daily New Lows (5-Day Av.)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Sales Ratio
Short Interest on N.Y.S.E.
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of Stocks Bullish on the N.Y.S.E.
Russell Volume Index
Eurosyndicat Index of the 100 Largest Corporations in Europe
London Stock Average
Merkle Index of Stock Market Activity
South African Gold Average
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

strength in the Averages, the new high index has been trending lower.

The point is that this market has been issuing technical warnings ever since June and July. It has been saying that the strength in the Dow has not been matched or confirmed by strength in other indicators. Barron's Confidence Index (which nobody seems to watch these days) has been calling for weakness in the September-November area, and this was covered thoroughly in preceding Letters.

Barron's Low Priced Stock Index, which characteristically tends to top out ahead of the Dow, recorded its 1968 peak on June 21 at 422.8. With the Low-Priced Index offering a four-month lead time, it would not be unusual to see the Dow Averages run into trouble as speculative interest in the "cats-and-dogs" wanes.

Most people seem to have been heartened by the most recent run-up in the Dow stocks despite a cessation of interest in the low-price issues and glamor shares. But a study of history does not support optimism regarding this type of action. What it amounts to is a movement of money out of speculative vehicles and into the relative safety of the "big, blue-chip stocks." This is the sort of action which has marked the end of many important movements in the market.



DOW THEORY: When, a few weeks ago, the Averages bettered their peaks of last July, Wall Street suddenly rediscovered "the Dow Theory." From all sides came word that "it's a bull market." I disagree. Those who are reading that it is a new bull market are taking a mechanical view of the Dow Theory, and such procedure is always dangerous.

The new, amateur Dow Theorists are disregarding the bigger picture. They are forgetting that no real correction of the great 1949-1966 bull market has yet taken place. True, between February and October, 1966, the Dow dropped from 995.15 to 744.32, a decline which consumed 8 months. But the 1966 decline hardly qualified as a correction of a 17-year bull market, a bull market which took the Dow from 161.60 (1949) to 995.15 (1966), a distance of 834 points on the Dow. To put it another way, no 17-year bull market could possibly be corrected by an 8-month decline.

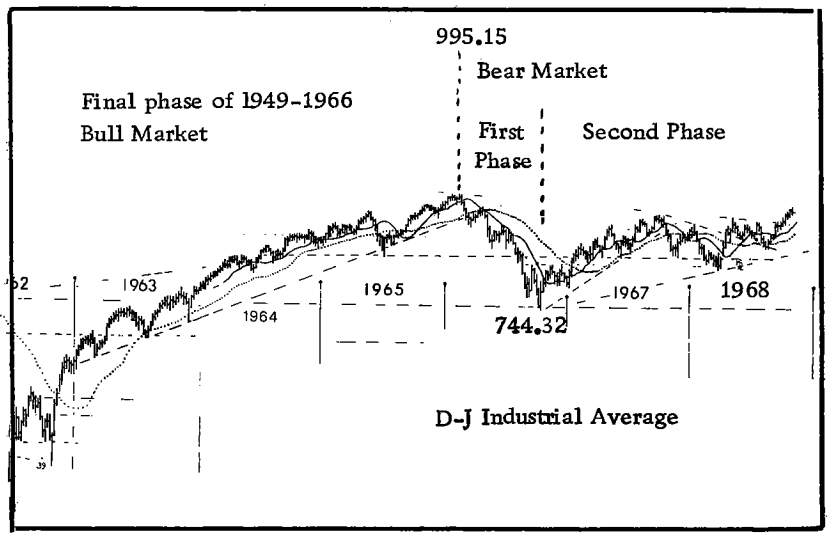
This same problem of haphazard interpretation of Dow's Theory has come up many times before. On September 16, 1936, Robert Rhea took the amateur Dow Theorists to task when he wrote:

"Students generally pay entirely too much attention to the matter of penetration of a previous high or low point, while disregarding other evidence to be found in the Averages, such as volume indications, the position of prices with reference to the duration or extent of the primary and secondary movements, and the degree of correction attained or due. Consequently, when a reversal follows quickly upon the heels of a penetration of a previously established high or low point, thus upsetting their hopes and expectations, some of our readers are prone to complain bitterly, and to insist that Dow's Theory is no more to be depended upon than the word of Roosevelt."

Based on past history, a bear market can be expected to last approximately one-third as long as the preceding bull market. Most bear markets in history have wiped out half or more of the preceding bull market's gains. Applying these observations to the current affair, we might (starting with February, 1966) now expect a bear market of about 5 to 6 years duration, a bear market which could easily wipe out half or more of the 834 Dow points gained between 1949 and 1966. A decline wiping out half of the 834 points since 1949 would take the Dow to 587, and this might

be considered a "normal" correction of the excesses of 1949-1966. Such a decline might be expected to last at least five years. If so, expectations as to the ultimate bottom of this bear market would center around the 1971-72 period.

I include a weekly chart of the Dow published by Quote Digest (110 N. Lorraine, Wichita, Kansas). I have marked the chart as I see it. The stock market is always a pleasure to interpret in retrospect. To interpret it at the time is the hardest thing I know. If one studies all past bull and bear markets, one can come away making sense out of what occurred. There have been broad upward swings, mostly of two years or longer, and these may be referred to as bull markets. There have been broad downward movements or major corrections, and these may be called bear markets.



This phenomenon of bull and bear markets is the single most obvious factor in past stock market history. What is most confusing is that no two bull markets or bear markets have ever been alike. Nevertheless, there have been certain similarities. One of the similarities is that the bear markets do seem to bear a certain relationship to the bull markets which preceded them. When a great bull market occurs, it is ultimately corrected by an important and extended bear market. Where a minor bull market takes place, the ensuing bear market is usually minor in duration and extent.

Obviously, political, social and economic events at the time have a great deal to do with how a given bull or bear market unfolds. But the interesting thing is that although events do influence the actual pattern of the Averages, every bull market eventually runs its course, and every bear market eventually runs its course.

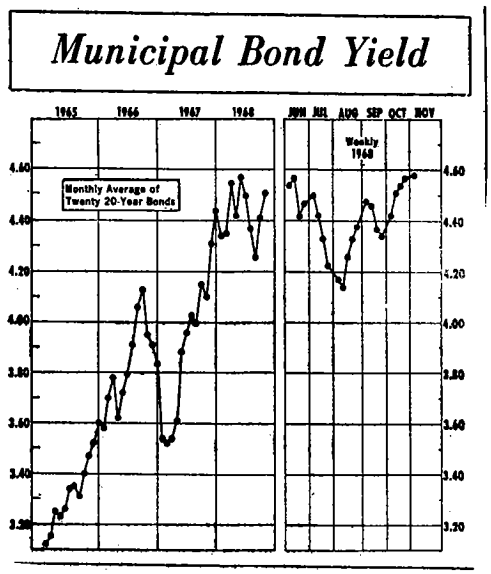
Referring to the chart, we see that the first phase of the bear market which followed the 1966 highs was rather minor in duration and extent. This initial first phase decline dampened speculation temporarily, but during the period of 1967-68 the U.S. Government opened the flood-gates of inflation, removed the gold backing from the dollar, and pumped new money into the economy at an unprecedented rate. In my opinion, this amazing, inflationary spree sponsored by the Administration served to extend what might have been a normal (upward) correction into the most remarkably speculative and extended bear market rallies in Wall Street annals.

During 1968 we have had extensions of the rally which have been successively termed the "Nixon bull market" and the "Vietnam peace rally." I feel reasonably certain that the 1968 rise, so far, has largely discounted the good effects and optimism connected with both a Nixon victory and a Vietnam peace. Yet many investors are obviously banking on a further huge extension of the rise should one or both of these events materialize. This is dangerous thinking. The market has an uncanny way of discounting events fully well in advance, and I believe that both a Nixon victory and a Vietnam peace have been rather fully discounted by the Industrial and Rail Averages. To expect the market to surge on the actual news of either event may turn out to be wishful thinking.

It should also be pointed out that a great deal of the buying of the past year or so has been done by the rankest amateurs. The public has been sucked into this market either directly or through the funds at an unprecedented rate. The market value of stocks held by individuals is now around $650 billion, up approximately $100 billion for the year. This titanic surge in public ownership has come at a time when Dow's Theory holds that a primary bear trend is in force, it has come at a time when stocks are historically unattractive on the basis of the classic stock-bond yield spread (for instance, the spread between the yields on the D-J Industrials and Barron's 10 Highest-Grade Bonds is now 3% in favor of bonds).

In talking to many stock holders, I get the feeling that very few are taking any sort of long-term view of the market. They have no firm conviction as to whether a bull or bear market is in force, they do not even have a real conviction as to whether the nation is going to be better off next year than this (regardless of who becomes President). People have been buying stocks because they have been told that inflation is a perpetual proposition, and because they believe that somehow things have to be better next year than this. Conversely, they are disregarding the problems connected with a possible Vietnam peace, and contraction of arms-building, the gathering monetary mess, a potential stalemate between a Republican Nixon and a Democratic Congress. In all my years of observing the market, I do not feel that I have seen such fuzzy, anxious, confused thinking in the face of such optimism in the market. I do not think it will last much longer.

MONEY: A few weeks ago I presented a chart of the bellwether U.S. Treasury bond, the 4¼ of 1987-92. In so doing, I was directing attention to the new money-rate squeeze which is coming into play. Last week the situation became more dramatic as the short-term market also tightened up. The 91-day Treasury bills jumped in yield for the fifth week in a row—to 5.47%, highest yield since June.



Moving in unison was the D-J Municipal Bond Yield (see chart) as it pushed steadily above the September peak in what appears to be a try for the all-time record for tax-exempt Municipal yields established back in May.

What can save the bond market from caving in, thereby sending yields on all debt instruments from going through the roof? One possibility is an ending to the Vietnam war. A peace would at least establish the possibility of a slowdown in military purchases, thereby easing the pressure for new money. A second possibility would be a conservative turn by a new President in an attempt to hold back the inflationary forces which are enveloping this nation. Perhaps in the same category would be a general slowdown in the U.S. economy, set off by a change in consumer psychology. Finally, a stock market collapse could also serve to lower interest rates, and here two factors would operate. First, money leaving the stock market would to a large extent move into the more conservative long-term and short-term debt market. Second, a stock market collapse could easily touch off a business slowdown, and slower business means less need for money.

But suppose conditions continue with no major change? For one thing, we can expect steadily mounting pressure in the bond market as cities, states and counties move forward with grandiose plans for expansion and reconstruction of slum blight. Such thinking is already serving to produce a steadily mounting bulge in the bond calendar.

With the approach of election time and the probability of a Nixon victory, it is well to note that Mr. Nixon is talking about the "missile gap," and his plans to compete with Russia in weaponry have been variously estimated at $25 to $50 billion. Any such ventures are sure to place additional pressure on the money market for a long time to come.

Finally, according to the authoritative Weekly Bond Buyer (Oct. 21), the Federal Reserve Board does seem to have plans for slowing down inflation. The "plan" seems to be to bring the inflation rate down to 3.5% by the end of this year, 2.5% by the end of 1969 and 1.5% by the end of 1970. Since such plans must entail the use of money supply and interest rates, we thereby have another factor for high interest rates.

While I was writing this my Wall Street Journal arrived. This little front-page squib was, I thought, directly in line with what I have been writing above.

Bond issues by state and local governments amounting to about $9 billion will be up for approval tomorrow. The total is more than twice the previous high of $3.8 billion submitted to the voters in November 1960. Among the proposals will be a plan by Los Angeles County to sell $2.5 billion of general obligation bonds to finance a giant public transportation system.

PROBLEMS: As I read the headlines and listen to the newscasts over the radio I realize that the Johnson Administration is master of the big "put-on." Keep talking, keep saying what people want to hear, and who knows, maybe everyone will begin to believe it. The Johnson Administration has espoused this deceptive public relations policy all down the line. The policy has been shoved down the throats of the American people so often that the real election word is, "If he's not LBJ, he's got a chance to win the election."

There is no doubt but that Hubert Humphrey's election loss (if he loses) will represent a massive protest against the Johnson Administration and its tactics. There are millions more Democrats than Republicans in this nation. When the Democrats lose an election, it is always to a lesser or greater extent, a form of mass protest.

If Humphrey loses the election it will be because of one main reason; he never disassociated himself from LBJ. The main body of Democrats throughout the nation wanted a "new Democrat" for 1969, one that they could trust and identify with. Many thought that McCarthy was the man, but the old party-liners did not trust a new man without "proven" organization ties. The party shoved Humphrey down the throats of the American voters, and to most people this was typical of what had been going on all along.

The news handouts of this Administration have been a lie, the handling of the Vietnam war has been a lie, the fiscal policy of this Administration has been a lie, and since Hubert Humphrey has failed to disassociate himself from this Administration— he himself has become part of the lie.

Last week President Johnson announced a cessation of all bombing in North Vietnam, this on the basis that such was the advice of his top military advisors. No one could have failed to be struck by the fact that this sudden "advice" came only one week before the election. What saved Johnson from real criticism about his timing was the fact that the war involves lives and is really above politics. In his shrewdness, Johnson counted on this to counteract criticism regarding his peculiar timing.

The peace offer (as the market seems to know) presents many new problems. First, Russia will back Hanoi while China (always on the opposing side) will back the Vietcong. Second, since all Communist negotiations are referred to committees, the negotiations are likely to take longer than anyone now suspects. Third, Hanoi's minimum demands may be more than the U.S. will be willing to accept and still "save face." The minimum demands from Hanoi will probably be a Communist dominated coalition government in South Vietnam along with the exit of literally all American troops. Fourth, it now appears that Hanoi has taken the bomb halt as a sign of U.S. weakness rather than good intentions.

Too many Americans lose sight of the fact that Hanoi has been fighting this fight for a long, long time, and they mean to come up with a settlement which is highly favorable to them. They are fully aware of the great unpopularity of the war in the U.S. and they can be expected to capitalize on this knowledge by holding out for the most advantageous terms. It is a question of whether the U.S. will be able to stomach the final terms for which Hanoi will settle.

Finally, there is the huge problem of South Vietnam. South Vietnam was not warned of the bombing halt, which they regard as part of an American sell-out on the installment plan. As this is written, South Vietnam announces they will not appear at the negotiating table, they they will fight on, and they they will fight harder than ever. Anti-Americanism has suddenly swept South Vietnam, and the mild-mannered South Vietnamese Premier is now talking with great bitterness. It's going to be a long, difficult way ahead.

NOTES AND QUOTES: From Reuters financial editor, Sydney Gampell regarding the last IMF meeting: "As a fair consensus of the Washington meeting from the IMF's Pierre Schweitzer downwards, the dollar is just as good as gold except that gold is rather better."

* * * *

Few people realize that the IMF's famous Special Drawing Rights have up to date received ratification from only 17 nations. It will take ratification from 67 nations to put the Drawing Rights (or paper gold plan) into effect.

* * * *

Despite all the propaganda against gold, the price of the yellow metal continues to hold or move higher. Since mid-August, the London dollar price of gold has been under $39 on only three days. Following the July, 1968 low of $37.80, the price of gold rose to a September high of $40.50. Gold then declined to an October low of $38.90, following which it rallied to last week's high of $39.50. I would consider any rally to above the Sept. $40.50 peak as a major breakout for gold.

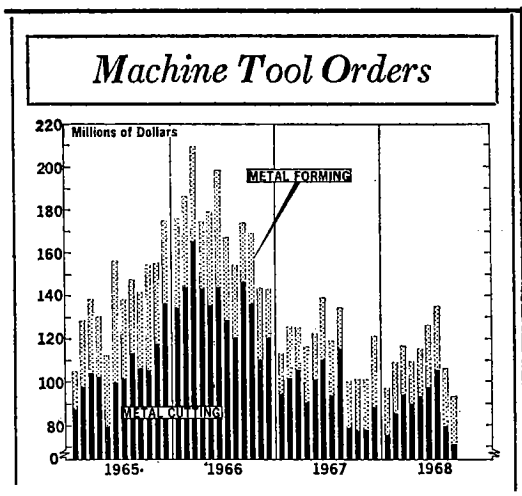
* * * *

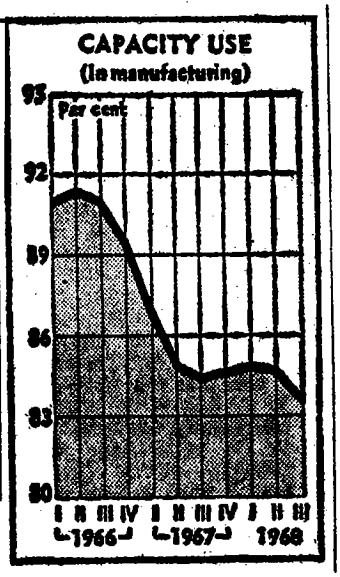
One suspects that Nixon would have accepted a Vietnam peace settlement before the election (with any benefits it would give Humphrey) rather than have to face the problem himself (if he wins) after election. The pressure on the new President to finish off Vietnam will be intense, and Hanoi knows it. Furthermore, if Vietnam is not settled, Nixon may be tempted to settle fast after elections, claiming that it was not his war and that he had to get out of a Democratic mess the best way possible. This too, Hanoi knows.

* * * *

Despite the economic boom, two areas pose mysteries. One is machine tool orders which (see chart) have dropped to the lowest level in years. Machine tool orders are considered a barometer of forthcoming capital expansion. A second problem is plant capacity, which has now dropped to 83.4%, lowest level since early 1963 (see chart).

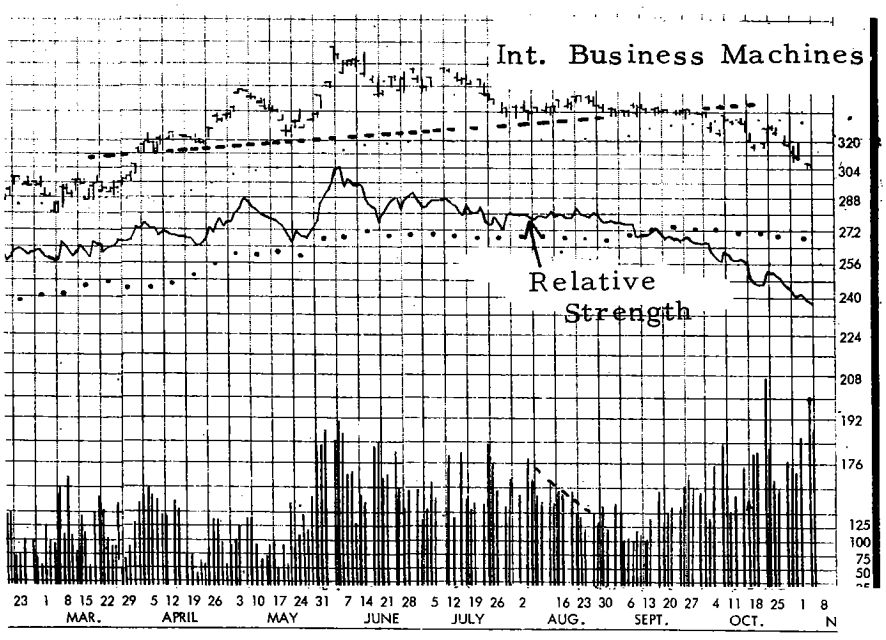
While the steel slow-down is an undoubted factor here, it does not seem to explain the whole phenomenon. Machine tool orders and plant use are inter-related, in that manufacturers with huge unused capacity are hardly likely to place orders for new plants and new tools to service those plants.





DOW THEORY MARKET LABORATORY PAGE

In this week's report, Investor Research of Santa Barbara asks, "Can anyone point out one instance in the past 20 years when the great speculative leadership of a bull market was beginning to collapse, that the entire market did not turn down shortly afterward? And it did not matter what that leadership was composed of— blue chips, cyclical or growth stocks."



I pointed out in the last Letter that Barron's Low-Priced Stock Index (which is highly speculative) topped out four months ago. And as seen on the accompanying chart, so did one of the U.S.'s leading growth stocks, IBM. As seen on the accompanying chart, IBM starting running into trouble after its June high. Note that the rally into July produced a decline in volume, and thereafter the relative strength line on IBM headed unceremoniously down.

The whole top which formed in IBM during April to September has taken the form of an extended "head-and-shoulder" effect. With the breaking of the 320 level a few weeks ago, IBM began sinking in earnest. With it have gone many other leading glamor and growth issues. (Chart courtesy Traders Research, 101 Cherry St., Alton, Ill. 62002).